

**M. DONOR DIRECTED FUNDS**  
by  
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1. Introduction

In most situations, once a donor has made a gift to charity, the gift becomes the property of the charitable organization and the donor retains little authority over use or expenditure of the funds. The Internal Revenue Code and Treasury Regulations offer only two significant ways for charitable donors to exercise any post-transfer control or direction over the use of cash or property irrevocably transferred to charity for which the donor is entitled to a charitable deduction in the year of the transfer. One mechanism is the community trust described under Reg. 1.170A-9(e)(10) through (13). The community trust regulations and Reg. 1.507-2(a)(8) only allow donor designation at the time of the gift and donor "advice," not donor direction, after the date of the gift. The second mechanism for a donor directed fund is the special type of private foundation described in IRC 170(b)(1)(A)(vii) and 170(b)(1)(E)(iii).

A number of commercial companies are now offering and aggressively promoting the use of donor directed funds that do not fit the traditional mold of either a community trust or a pooled common fund described in IRC 170(b)(1)(E)(iii). Some donor directed programs are marketed nationally, and a number of these programs have a significant potential for tax abuse. The focus of this article is the use and possible abuse of commercial donor directed funds. Of particular importance is whether the commercial donor directed fund is entitled to avoid the restrictions and limitations of private foundation classification.

2. Community Trusts

An article in the 1994 CPE Text, Community Foundations, at p. 135, discusses the rules governing the use of community trusts as described in the regulations as well as practical issues related to the use of community trusts. The degree of control permitted to the donor of a component fund of a community trust is also discussed.

In summary, the regulations allow a donor, at the time of the creation of the component fund (that is, the time of the gift in trust), to designate the charitable purpose of the gift or the specific charity that will receive the income or principal,

consistent with the community foundation's exempt purposes. See Reg. 1.170A-9(e)(11)(ii)(B); 1.507-2(a)(8)(iii)(B); 1.507-2(a)(8)(v), Example (3). The regulations do not permit the donor to direct, aside from the designation of a charity at the time of the gift to the component fund, which charity may receive distributions or the timing of the distributions to the charitable recipient. See Reg. 1.507-2(a)(8)(iv)(A)(1). The donor may also offer non-binding advice to the community trust manager regarding any payout from the trust. Where the donor offers advice, the Service will examine carefully whether the giving of advice by the donor constitutes an indirect reservation of a right to direct such distributions.

An additional check on the donor's advice or gift designation privilege is found in the powers required to be set forth in the community trust's governing instrument. Under Reg. 1.170A-9(e)(11)(iv) all funds must be subject to the common governing instrument. That instrument must provide the governing body of the community trust with the power to modify the condition or restriction on the distribution of funds for any specified charitable cause if, within the sole discretion of the governing body, such restriction or condition becomes unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community. Reg. 1.170A-9(e)(11)(v)(B). In addition, under Reg. 1.170A-9(e)(11)(e)(v), the governing body must be committed to the exercise of the power of modification. A governing body that fails to exercise this "cy pres" power when there are grounds to do so may not be considered committed to its exercise.

Another element of community trusts discussed in the 1994 article is the fact that the regulations create a fiction that the community trust is a single entity when, in fact, it is frequently an aggregation of trusts and funds held by the local community banks and trust companies. However, for tax purposes, the component funds of a community trust are treated as a single entity. See Reg. 1.170A-9(e)(11)(i). The requirements for qualifying for single entity status are found in Reg. 1.170A-9(e)(11)(iii)-(vi).

As explained in the CPE article (pages 137-138) an important aspect to the fiction that the community trust is a single entity is that "most" community trusts will qualify as publicly supported charities under IRC 509(a)(1) and 170(b)(1)(A)(vi). Others may qualify under IRC 509(a)(2) or (a)(3). The separate trust funds of a community trust, if not covered by the public charity status of the umbrella organization, would in many (if not most) instances be private foundations. Thus, there are significant tax benefits to the community trust and its donors, as well as the advantage to the donor of being permitted to offer "advice"

on use of the gift from time to time.

Because of the advantages offered by community trusts, the implementing regulations are detailed and complex in an attempt to prevent abuse of the private foundation rules. The 1994 article explained the issue as follows, at p. 140:

The community trust's structure coupled with its promotion of funds giving donors a degree of control make it a tempting target for those seeking to avoid the private foundation restrictions. Therefore, Treas. Reg. 1.170A-9(e)(11) was carefully drafted to strike a balance between competing concerns. The Service wanted to treat favorably those organizations possessing the characteristics of then existing community foundations, and to prevent any attempts to avoid the private foundation restrictions. Thus, the Service specified in detail the characteristics thought to be representative of community trusts to prevent any loosely organized group of funds from claiming the benefits of the regulations.

### 3. IRC 170(b)(1)(E)(iii) "Pooled Common Funds"

IRC 170(b)(1)(E)(iii) describes a "pooled common fund", which is a private foundation. Under IRC 170(b)(1)(A)(vii), contributions to such funds receive the same charitable deduction as gifts to public charities described in IRC 170(b)(1)(A)(i)-(vi). (Other organizations described in IRC 170(b)(1)(E) receive the same favorable treatment. These include operating foundations (IRC 170(b)(1)(E)(i)) and "flow-through" foundations (IRC 170(b)(1)(E)(ii)). The charitable deduction rules are discussed in greater detail below.)

Under the Code, a "pooled common fund" must distribute all its adjusted net income to public charities not later than the 15th day of the third month after the close of its taxable year. Income may be distributed in accordance with the annual direction of the donor. Principal (corpus) of any donor's gift must be distributed within one year after the donor's death (or that of his or her spouse). A pooled common fund must be an organization that would be described in IRC 509(a)(3) were it not for the right of substantial contributors to designate the recipient of income and corpus attributable to their gifts.

Special charitable deduction treatment was provided for pooled common funds by the Tax Reform Act of 1969, as part of the statutory scheme for private foundations. The legislative history indicates that pooled common funds were

accorded the 50 percent charitable contribution limitation because Congress thought that without the special provision, community foundations would be unduly restricted in the charitable contributions they could receive. In fact, community foundations would be precluded from the more beneficial 50 percent limitation by virtue of the donor's right to designate the charitable recipient. See 115 Cong. Rec. S37496 (Dec. 6, 1969) (statement of Sen. Scott).

#### 4. Commercial Donor Directed Funds

Several commercial entities now offer national programs featuring donor designated and donor directed charitable funds. The features of a hypothetical program are set forth below to illustrate the issues associated with commercial donor directed charitable funds.

- . The charitable fund is a pooled fund with a separate account balance maintained for each donor.
- . The donor has the right to recommend to the fund trustees qualified tax exempt organizations to receive distributions from the fund from time to time. If the donor's recommendation is not accepted by the fund trustee, the trustee will make a reasonable effort to solicit donor's recommendation for an alternate distribution.
- . The fund's promotional literature states that contributions to the fund qualify for a current income tax deduction.
- . The literature states that all activities of the fund including donor participation are subject to the conditions of the fund's trust document and that the fund reserves the right to modify the program. In addition, the document states that any contribution to the fund is irrevocable and non-refundable.
- . The fund sets up a separate sub-account for each donor but asserts ownership of the assets of the sub-account; the donor has only the rights vested by the fund trust document.
- . Donor distributions may be made from sub-account income or principal, but the fund reserves the right to distribute income to preserve the fund's exempt status.

- . Upon the donor's death, his or her sub-account will be distributed to the IRC 501(c)(3) public charity designated by the donor. If none was designated, the fund's trustees will select the charity. If, however, the donor has a successor election in effect at the time of death, the sub-account will continue.
- . If a successor election was made, the sub-account will continue and the donor's successor (spouse, child, or other descendant) may continue to make recommendations regarding distributions from the sub-account.
- . The donor's sub-account is subject to fund fees.
- . The fund's promotional material describes the income tax benefits (increased charitable deduction, as discussed below) and alludes to estate planning benefits. The promotional material also suggests that the fund is a means to avoid private foundation rules and excise taxes.
- . In addition to the tax advantages, the fund's promotional literature lists the advantages of (1) anonymity, (2) no start-up costs, and (3), legal, administrative, and accounting to be performed by the fund. In comparison, the private foundation offers no such advantages.

The hypothetical fund's promotional literature is an accurate description of the tax advantages to the donor of a contribution to an entity having public charity status as compared to a charitable contribution to a private foundation. For an individual, the charitable contribution limitation under IRC 170(b)(1)(A) for a gift to a public charity is 50 percent of the taxpayer's contribution base for the year. In contrast, IRC 170(b)(1)(B) generally provides a 30 percent limitation for a gift to a private foundation. For contributions of capital gain property, gifts to public charities are subject to a limitation of 30 percent of the taxpayer's contribution base under IRC 170(b)(1)(C), in contrast to the 20 percent limitation under IRC 170(b)(1)(D) for gifts to private foundations. Gifts of capital gain property to private foundations are further reduced by the amount of gain that would have been long-term capital gain if the property had been sold by the taxpayer. IRC 170(e)(1)(B).

In addition, the excise taxes and other restrictions mandated by Chapter 42 are only imposed on private foundations as defined under IRC 509 and on certain split interest trusts. Chapter 42 does not apply to public charities.

## 5. Private Foundation Status

Concern about perceived tax abuses associated with commercial donor directed funds is reduced if the donor directed foundation fails to qualify for public charity status. As a private foundation, potential earmarking in the form of contribution "laundering" activities is prohibited under IRC 4941 and 4945. See, e.g., Reg. 53.4941(d)-1(b); 53.4945-2(a)(6); Topic O, 1995 CPE Text, pp. 282-86.

Publication of G.C.M. 39748 (Aug. 3, 1988) may have encouraged the use of donor directed funds. See Bank, Community Foundations: Are "Donor Directed" Funds New Vehicles for Utilizing Community Foundations?, The Exempt Organization Tax Review (Jan. 1993). Whether or not G.C.M. 39748 was a contributing factor to the growing trend in the commercialization of donor directed funds, it was withdrawn by the Service with G.C.M. 39875 (June 26, 1992), and does not represent the Service's position.

A controversial aspect of G.C.M. 39748 was its conclusion that "earmarked" contributions constitute support for the intermediary organization as well as for the recipient organization in determining if the intermediary organization is publicly supported as defined in IRC 170(b)(1)(A)(vi) and 509(a)(1). The "earmarking" concept is illustrated by the following examples:

**Example 1** Donor A transfers \$10,000 cash to corporate charitable fund X with instructions to transfer the same amount of cash in two years to Charity Z.

**Example 2** Donor A transfers \$10,000 cash to corporate charitable fund X without any specific instruction but with the right to direct the expenditure of the cash as Donor A may choose within his discretion. Two years later Donor A directs X to transfer \$10,000 to Charity Z.

G.C.M. 39748 concluded that the \$10,000 would count as support for Charity Z in both examples and thus be subject to the 2 percent limitation provided by Reg. 1.170A-9(e)(6)(i) since the exception for grants by IRC 170(b)(1)(A)(vi) organizations or governmental units under Reg. 1.170A-9(e)(6)(v) is not applicable to earmarked funds. Reg. 1.170A-9(e)(6)(v) and 1.509(a)-(3)(j)(3) provide that in the hands of the ultimate recipient, earmarked funds such as those described are subject to the 2 percent of support limitation in Reg. 1.170A-9(e)(6)(i) as though they were received from the original donor. (See also

Reg. 1.509(a)-3(j)(2), which adopts a similar "earmarking rule under IRC 509(a)(2).) The G.C.M. reasoned that these regulations did not preclude the intermediary organization - Fund X - from including the \$10,000 cash as support for purposes of its support test.

While G.C.M. 39875 withdrew G.C.M. 39748, it does not provide a new analysis. The National Office is currently considering the appropriate treatment of "earmarked" or "directed" contributions in public support determinations. Arguments against including such contributions as "support" to intermediary organizations are addressed below.

**The regulations do not allow multiple organizations to include a single gift as support to each of them.**

The regulations clearly provide for earmarked contributions to be included in determining support for the ultimate beneficiary. That they are also to be included in determining support for the intermediary organization is not clear from the regulations, however. A lack of clarity in the regulations allows the opening for the argument that the same gift should be included in both determinations, as was asserted in G.C.M. 39748. The analysis for arriving at the technical position that only one organization, the ultimate recipient, is entitled to include earmarked funds in determining support requires winding a path through the Code (IRC 170 and 509) and the regulations (Reg. 1.170-(9)(e) and 1.509(a)).

IRC 509(a) provides that organizations described in IRC 501(c)(3) are private foundations unless they are described in IRC 509(a)(1), (2), or (3). IRC 509(a)(1) refers to organizations described in IRC 170(b)(1)(A), other than those organizations described in clauses (vii) or (viii).

IRC 170(b)(1)(A)(vi) describes an organization that normally receives a substantial part of its support (exclusive of "exempt function" income) from a governmental unit referred to in subsection (c)(1) or from direct or indirect contributions from the public. The regulations provide two tests to determine whether an organization will be treated as "publicly supported" for purposes of IRC 170(b)(1)(A)(vi). These tests are the 33-1/3 percent test and the 10 percent, facts and circumstances test. See Reg. 1.170A-9(e)(2)-(3).

The regulations generally limit "support from the public" from any single donor to two percent of the organization's total support. See Reg. 1.170A-9(e)(6)(i). Reg. 1.170-9(e)(6)(v), however, provides that contributions

received from a governmental unit or from a IRC 170(b)(1)(A)(vi) organization are not subject to the 2 percent limitation described in Reg. 1.170A-9(e)(6)(i) unless such contributions represent amounts which have been expressly or impliedly earmarked by a donor to such organization as being for, or for the benefit of, the particular organization claiming IRC 170(b)(1)(A)(vi) status. Reference is made in the regulations to Reg. 1.509(a)-3(j)(3) for examples.

Reg. 1.509(a)-3(j)(1) requires the examination of whether the recipient of a grant from a public charity has received the grant from the public charity as a grant, or whether the recipient has received such support as an indirect contribution from a donor to the public charity. In the latter case, the recipient will treat the contribution that passed through the public charity as retaining its character as a contribution from the original donor. Thus, the contribution will be treated as support to the ultimate recipient to the extent allowed by the regulations cited above.

Thus, the regulations clearly treat the earmarked gift as support for the ultimate recipient. There is no authority in the regulations or elsewhere that the earmarked funds are treated as support for the intermediary organization as well as the ultimate recipient. Arguably, then, they are not included in the latter instance.

**Only contributions "to" an organization are "support" included in its public support determinations; contributions it receives "for the use of" another organization do not count.**

There is a parallel between contributions "to" charity for purposes of the charitable deduction under IRC 170(c) and gifts, grants, contributions, or membership fees to charity for purposes of IRC 509(d) in determining public support for private foundation classification purposes. A charitable contribution under IRC 170 may take one of two forms. A contribution "to" a charitable organization is an outright gift to charity qualifying the donor for the more generous charitable contribution limitation provided by IRC 170(b)(1)(A). In contrast, the donor's contribution "for the use of" a charitable organization is generally equated with a gift in trust (there are exceptions) which, if it qualifies for a charitable deduction to any extent, qualifies the donor for the less generous charitable contribution limitation of IRC 170(b)(1)(B). See, e.g., Rev. Rul. 60-110, 1960-1 C.B. 121 (greater limitation applicable to contributions "to" 170(b)(1)(A) organizations not available where contribution made in trust for benefit of university, a 170(b)(1)(A) organization). On the trust issue, see Reg. 1.170A-8(a)(2); Davis v. United States, 495 U.S. 472 (1990); Topic E, this text.



IRC 509(d) defines support to include gifts, grants, contributions, or membership fees without indicating whether the contribution must be made "to" the organization as the term "to" would be used under IRC 170. Reg.

1.509(a)-(3)(j)(1) discusses earmarked funds in the context of the IRC 509(a)(2) support test. The regulations provide, in part, that it is sometimes necessary to determine whether the recipient of a grant from a public charity has received the support from the public charity as a grant, or whether the recipient has in fact received the support as an indirect contribution from a donor to the public charity.

"Earmarked" contributions and "direct" and "indirect" contributions are discussed in various parts of the regulations. There was a concern that taxpayers might attempt to "launder" contributions through public charities for the ultimate benefit of private foundations or other entities which, if made directly by the donor, would not qualify for the same deduction as secured by the indirect route. Reg. 1.509(a)-3(j)(1) and 1.170A-9(e)(6)(v) address this concern.

Arguably, IRC 170 makes the same distinction as IRC 509, in the sense that an outright contribution "to" charity, free of trust, is property held by the charity to be used in its unfettered discretion. The gift is "support" to the charity since the charity is free to use it in its charitable program. In contrast, an earmarked gift is similar to the contribution "for the use of" in that both have qualities of property held in trust. The intermediary organization with respect to the earmarked gift is the equivalent of the trustee or nominee of property in trust. Neither may use the gift except as directed by the original transferor for the use of the ultimate recipient or beneficiary.

Thus, it can be argued that in applying the support tests under IRC 509, only the organization that has free and unfettered use of the gift - i.e., the ultimate recipient - should be entitled to treat it as support.

The community trust regulations contain a similar concept regarding gifts made "to" an entity. Reg. 1.170A-9(e)(14) spells out the consequences of the failure of a trust or fund to qualify as a component part of a community trust. As described above, a community trust meeting the requirements of the regulations is treated as a single entity even though it is made up of separate component funds. The single entity treatment is fictional. However, under Reg. 1.170A-9(e)(14), where the fund fails to qualify as a component part, any transfers or gifts to such fund will not be treated as made "to" to the community trust since the non-component fund is not allowed the fiction that it is part of the single entity. In

contrast, under Reg. 1.170A-9(e)(11)(ii), transfers to a "component part" are treated as transfers made "to" the community trust.

Thus, the qualifying community trust may be viewed as an exception to the notion discussed above that for public support test purposes, a charitable gift must be made "to" the organization. The gift may be made to the component fund "for the use of" the community trust. However, as discussed above, the fiction that the community trust is a single entity allows the gift to be counted as part of the support of the community trust under IRC 509.

**Including earmarked contributions as public support to intermediary organizations contravenes Congressional intent in enacting the private foundation provisions of the 1969 Tax Reform Act.**

The private foundation provisions of the 1969 Tax Reform Act serve two functions: (1) to delineate classes of organizations Congress believed should be subject to greater oversight and restrictions than others, and (2) to delineate classes of contributions Congress felt were entitled to favorable deduction treatment. The second function is served where contributions are received by an organization that puts them to immediate (or near immediate) use in charitable programs.

The first function of the private foundation classification is, generally, to describe organizations that will be "responsive to the needs of the public." See, e.g., H.R. Rep. No. 91-413, 91st Cong., 1st Sess. 41 (Aug. 2, 1969), reprinted at 1969-3 C.B. 200, 227. The "donor discipline" rationale applicable to public charities is well-documented in the legislative history; for a discussion, see Williams & Moorehead, An Analysis of the Federal Tax Distinctions Between Public and Private Charitable Organizations, in IV Commission on Private Philanthropy and Public Needs, Research Papers 2099 (1977).

The classification provided in IRC 170(b)(1)(A)(vi) accomplishes the first function by describing organizations whose contributors will oversee its operations, presumably because they are interested in ensuring that the recipient charity properly applies the funds they have donated in its program. The structure of the regulations under IRC 170(b)(1)(A)(vi) indicates that an organization will be of the type Congress sought to describe if it depends on public support and therefore will be responsive to the demands of its supporters. Examples of the broad public support element are found throughout various provisions of Reg. 1.170A-9(e).

Where donors lack a financial stake in the intermediary organization, beyond trusting it to carry out its fiduciary responsibilities as trustee for the funds, the public oversight function is not being served. Thus, with earmarked funds, the intermediary organization is not "supported" in any real sense. With earmarked funds, one would expect any donor scrutiny to be directed to the ultimate recipient rather than to the pass-through entity. Allowing intermediary organizations to count as "support" funds earmarked for the benefit of other entities thus undermines the "donor discipline" function of the public support tests.

**Including earmarked contributions as "support" to the intermediary organization undermines special provisions for pass-through foundations and community trusts.**

Treating earmarked contributions as "support" under IRC 170(b)(1)(A)(vi) for commercial donor directed foundations would also undermine to a significant extent the considerations resulting in special treatment for IRC 170(b)(1)(E)(ii) and (iii) foundations and would render those provisions virtually obsolete. The community trust provisions of the regulations would also be undermined to a great extent.

From the donor's perspective, the donor directed commercial gift fund that is classified as a public charity is superior to the IRC 170(B)(1)(E)(iii) pooled fund, because it offers the same charitable contribution deduction under IRC 170 without the limitations of private foundation status and without the narrow time window allowed for donor direction for gifts of income imposed on donors to the IRC 170(b)(1)(E)(iii) pooled fund. Indeed, the more generous charitable contribution deduction for gifts to an entity that is essentially a private foundation with a donor directed feature may be attributable to the fact that the contributor must exercise his or her direction almost immediately as to all adjusted net income generated during the year. Under IRC 170(b)(1)(E)(iii), the contributor is required to distribute all income "not later than the 15th day of the third month after the close of the taxable year in which the income is realized." IRC 170(b)(1)(E)(iii) pooled funds are specifically defined as being private foundations, however, in recognition of the fact that the donor retains significant control over the principal of the gift until his or her death.

A second type of pass-through foundation is described in IRC 170(b)(1)(E)(ii). Under this section, contributors receive the more generous charitable deductions under IRC 170(b)(1)(A) if the foundation distributes all the

contributions it receives to a public charity within 2-1/2 months of the end of its fiscal year. This type of pass-through foundation would also become obsolete if donor directed funds received public charity status, as little incentive would exist to pass the funds through to public charities.

Similarly, the donor directed commercial fund is superior to the traditional community trust, again assuming the former attains public charity status, because it allows the donor greater control over contributions to the ultimate charitable recipient and avoids the rules for determining qualification under the community trust regulations. Although the community trust is also a hybrid vehicle like the IRC 170(b)(1)(E)(iii) pooled fund, the interests underlying the private foundation restrictions are protected by the restraints imposed on community trusts by the regulations.

## 6. Other Public Support Issues

### ***Can donor directed funds qualify as publicly supported organizations under IRC 509(a)(2)?***

As stated previously, the National Office is currently considering appropriate treatment of "earmarked" or "directed" contributions in public support determinations. Although the Service has no definitive position, the issues and arguments related to the IRC 509(a)(2) public charity are basically the same as those under IRC 509(a)(1) and 170(b)(1)(A)(vi). The support issue for the 509(a)(2) public charity is resolved in a manner similar to that discussed immediately above.

### ***Can a IRC 170(b)(1)(E)(iii) pooled fund qualify as a public charity?***

Some commentators have suggested that a IRC 170(b)(1)(E)(iii) pooled fund may qualify for public charity status under IRC 170(b)(1)(A)(vi) under appropriate circumstances. See Hoyt, Legal and Policy Issues Concerning Donor-Directed Funds, 1992 Fall Conference for Community Foundations, Council on Foundations, at 7; Hoyt, Legal Compendium for Community Foundations, at 53 (1991); and Troyer, Important Developments Affecting Private Foundations, The Exempt Organization Tax Review 213, at 214-15 (Feb. 1992).

With the creation of the private foundation rules as part of the 1969 Tax Act, there was perceived a need to encourage deductible charitable contributions with respect to gifts that may flow through a private foundation but would

ultimately (and fairly quickly) be received by a public charity. See P. Treusch, Tax-Exempt Charitable Organizations 572 (3d ed. 1988). Accordingly, certain pass-through private foundations received the charitable tax deduction benefit normally associated only with direct contributions to public charities. As discussed above, one such pass-through private foundation is the pooled fund described in IRC 170(b)(1)(E)(iii). A pooled fund supports specified public charities by pooling funds and permitting donors to determine when the gifts, which receive the charitable deduction at the time of transfer, are distributed to the ultimate charitable recipient. Thus, the IRC 170(b)(1)(E)(iii) pass-through private foundation is affiliated with a public charity, such as a community trust.

One could easily conclude that a IRC 170(b)(1)(E)(iii) pooled fund is a private foundation because that is how it is defined by the Code. But what of the IRC 170(b)(1)(E)(iii) fund with a large number of contributors - could it qualify under IRC 170(b)(1)(A)(vi)?

Arguably, the retained donor direction over the assets of the fund, which may be the reason that Congress described the fund as a private foundation initially, precludes status as a public charity. The right to exercise direction and control over the distribution of the assets (the corpus) of the fund for any charitable purpose up to one year after the last to die of the donor or the donor's spouse is similar to the right retained by the substantial contributor or creator of a private foundation under the traditional concept of that relationship. One could infer from the legislative history to the 1969 Tax Reform Act that Congress wanted to eliminate any techniques that might be used to get around the private foundation rules. However, the Service has no definitive position on the issue.

***Can a IRC 170(b)(1)(E)(iii) pooled fund qualify as a supporting organization under IRC 509(a)(3)?***

The private foundation described in IRC 170(b)(1)(E)(iii) by statutory definition fails to qualify for public charity status under IRC 509(a)(3). Rev. Rul. 80-305, 1980-2 C.B. 71, is the primary authority on this issue.

The trust considered in Rev. Rul. 80-305 is described in IRC 170(b)(1)(D)(iii) (now IRC 170(b)(1)(E)(iii)). It receives separate donations which are accounted for separately under the governing instrument, but are pooled in a common fund. Donors have the right to designate the charitable recipient of the income and corpus of their contributions as provided in the statute. The trust is controlled by the distribution committee of a community trust that is a publicly

supported organization described in IRC 170(b)(1)(A)(vi) and 509(a)(1).

A foundation is described as coming under IRC 170(b)(1)(E)(iii) if it would be described as a supporting organization under IRC 509(a)(3) but for the right of the donor (called a substantial contributor) to designate annually the charitable recipient that may receive the income attributable to the donor's gift of the fund. Reg. 1.509(a)-4(d)(2) provides that the "specified organizations" referred to in IRC 509(a)(3)(A) may be specified by class rather than by name, provided that the affiliated supporting organization requires that the fund be operated to benefit publicly supported organizations. The community trust considered in Rev. Rul. 80-305 exercises control over the pooled trust and distributes all of its income to IRC 509(a)(1) organizations pursuant to donor direction or on its own authority in the absence of donor direction.

Rev. Rul. 80-305 concludes that the donor's right to designate annually the charitable recipients constitutes control by substantial contributors for purposes of IRC 509(a)(3)(C). See Reg. 1.509(a)-4(j)(1). The control by substantial contributors thus precludes qualification as a supporting organization under IRC 509(a)(3)(C); but this failure ensures the organization's qualification under the statutory language of IRC 170(b)(1)(E)(iii).

## 7. National Foundation, Inc. v. United States

### **FACTS**

A key case in analyzing issues involving donor directed funds is National Foundation, Inc. v. United States, 13 Cl. Ct. 486 (1987). In National Foundation, the Claims Court considered the IRC 501(c)(3) status of an organization (NFI) the Service claimed operated a donor directed fund. NFI solicited contributions from potential donors usually through professionals called Charitable Development Officers (CDO's) who were accountants, attorneys, trust officers, stockbrokers, life underwriters, ministers, and representatives of charitable institutions; it paid CDO's a fee for procuring donors. NFI accepted donor contributions and charitable projects subject to its review and approval. Donated funds were distributed to existing IRC 501(c)(3) charities and operating projects that were in furtherance of NFI's charitable purposes.

NFI purportedly had standards to ensure that the donor's charitable beneficiary would be a IRC 501(c)(3) charity or otherwise qualify as a charitable endeavor. Each donor project was set up as a separate account of NFI and received

segregated internal accounting. The court's statement of the facts indicated that "NFI retains full control, ownership and discretion, and is not obligated to use the funds in the manner requested." In addition, the court found as a fact that "the sub-accounts do not represent separate funds or separate legal entities. NFI is the only legal entity."

As can be seen, the facts in this case in many respects resemble the hypothetical donor-directed fund described above. Indeed, many of the commercial funds now marketing their products claim to be "just like National Foundation."

## **ISSUES/ARGUMENTS**

The National Foundation case presented a number of factual and legal issues. The case was litigated by the Department of Justice before the Claims Court. The Service viewed the merits of the case as follows:

***Was NFI an aggregation of separate funds, rather than a single entity?*** The Service took the view that NFI was merely the trustee for each of the separate trust accounts. As such, NFI should have sought a group ruling; alternatively, each separate fund could file a proper application. Failure to do either prevented the Service from exercising its responsibilities to review in detail the charitable activities of applicant organizations, as required by IRC 508. For similar reasons, the separate funds (and NFI) were private foundations.

***As an aggregation of separate funds, could NFI qualify for exemption as a community trust?*** The Service took the view that the only avenue for separate funds to qualify for exemption as a single entity was as a community trust, under Reg. 1.170A-9(e)(10)-(13). Moreover, NFI and its funds failed in several respects to qualify under the community trust regulations. For example, its activities were not limited to a community or area, see Reg. 1.170A-9(e)(10) and (e)(11)(iii). Moreover, the separate funds of NFI failed to qualify as component funds of a community trust because, among other reasons, the donations received were subject to material restrictions by the donor as defined in Reg. 1.507-2(a)(8) in contravention of Reg. 1.170A-9(e)(11)(ii)(B).

***Did NFI serve the private interests of its donors?*** The Service took the view that NFI did not qualify under IRC 501(c)(3) because it did not operate exclusively for exempt purposes, it served the private interests of its donors, and its net earnings inured to the benefit of private individuals. Donors' private interests were served,

the Service contended, because donors could specify disbursements to particular individuals, thus circumventing IRC 170 and 501(c)(3) prohibitions on charitable contributions to individuals. See Reg. 1.501(c)(3)-1(d)(1)(ii); Rev. Rul. 67-367, 1967-2 C.B. 188. Specifying disbursements to non-exempt organizations may violate the requirements of Section 4945(d)(3) and (g) requiring advance Service approval of grant-making programs.

NFI's program also served the private interest of donors, the Service believed, by affording them a larger charitable deduction under IRC 170 than that to which they would be entitled if they contributed to a private foundation. If individual donors were to establish and fund their own charitable foundations, each fund would be classified as a private foundation. Accordingly, the contribution would be subject to the lower limitation of IRC 170(b)(1)(B), and the recipient foundation would be subject to the excise tax provisions of Chapter 42.

Finally, the Service believed that the business relationship between the CDO's and NFI resulted in a joint venture, under which NFI's earnings inured to the CDO's through the compensation arrangement. See Lorain Avenue Clinic v. Commissioner, 31 T.C. 141 (1958); Rev. Rul. 69-383, 1969-2 C.B. 113.

***Did NFI have a substantial nonexempt commercial purpose?*** NFI received fees for its services in providing accounting and trustee services to donor accounts, services similar to bank and bank trustee services. In addition, the CDO's received a fee for services similar to that of a tax planner or other advisor to the donor. Financial planning advice is not a charitable activity. Christian Stewardship Assistance, Inc. v. Commissioner, 70 T.C. 1037 (1978); Rev. Rul. 76-442, 1976-2 C.B. 148. Accordingly, the Service believed that NFI had a substantial nonexempt commercial purpose.

## **HOLDING**

The Court of Claims held that NFI qualified for exemption under IRC 501(c)(3). The court found that it furthered a charitable purpose by raising and distributing funds to other non-profit organizations in a manner similar to the United Way. The record contained no evidence that it was a commercial enterprise. On this issue, the Court of Claims stated, 13 Cl. Ct. at 492:

Defendant has cited no information . . . that indicates that NFI is a for-profit business that engages in commercial activities. There is not a scintilla of evidence in the record that NFI renders financial, tax, or



legal advice to its donors or has any intention of doing so.

The court also emphasized that NFI did not act as a mere conduit. Donors relinquished all ownership of the donated funds or property; the agreement between NFI and donors bound the parties and donors had no legal recourse should NFI reject a recommendation with respect to a distribution. The court also rejected the Service's inurement, private benefit, and private foundation arguments.

Given the facts found by the court in National Foundation, its holdings are, perhaps, unsurprising. The court found that NFI had and exercised discretion and control over donations, and did not merely act as a conduit between donors and ultimate beneficiaries. Most of the Service's arguments were premised on the conduit nature of the giving program. One can argue that if a gift fund's role is limited to administrative and managerial duties with respect to the funds it holds, it conducts no charitable program; and, as discussed above, funds it holds are not support to it. (It should be noted that National Foundation was a declaratory judgment action filed pursuant to IRC 7428. As such, the case was decided based upon an administrative record and without the benefit of a history of operations. Indeed, the Service viewed the facts in the case quite differently from the court's findings.)

Thus, even after National Foundation, determining as a matter of fact the precise nature of seemingly directed gifts remains the key in deciding both whether the fund is exempt and whether it is a private foundation. Although the Service does not agree with all the analyses in the holding of this case, it is also distinguishable on the facts from many of the situations addressed in this article.

## 8. The Future of Donor-Directed Issues

It is somewhat surprising that there is only one case, National Foundation, on a fundamental issue of such importance. Moreover, a number of significant issues raised in National Foundation have gone largely unaddressed by the Service or in the case law since the case was decided. What of the "separate entity" issue and all that such status would entail (including the requirement of a separate application for tax exempt status)? Equally interesting are the inurement and private benefit arguments in light of the expanding commercialization of donor directed funds. Of principal concern is whether these funds constitute private foundations.

Recent promotional material issued by commercial donor directed funds suggests added grounds to assert that some umbrella foundations are not single entities but, rather, aggregations of separate trusts or foundations. Such funds are increasingly explicit in emphasizing the benefits of donor control.

The features of some funds go far beyond the facts of National Foundation. Funds are separately invested at the direction of the donor. They are separately trusted by the donor's nominee. Control of the fund can be passed on to the donor's heirs in perpetuity. None of these rights were present in the facts recited by the court in National Foundation. Separate trust treatment for the individual funds is more appropriate in the presence of such significant donor rights.

Further, the aggressive marketing and promotion of some donor directed funds, including the extensive rights granted to the donor, are inconsistent with the need of the fund, if it is to fit within the holding of National Foundation, to exercise "independent discretion as to the charitable disbursement of the funds." 13 Cl. Ct. 486, at 493. If commercial donor directed funds were to fail to follow clients' directions as to the distribution of the funds to charity on a regular basis, they would not only likely lose clients, but could also be subject to lawsuit or other adverse legal consequences. One must question how an organization can maintain that it is the owner of funds when to exercise control or discretion over the funds would fly in the face of its advertising, alienate the goodwill of customers, and possibly subject it to adverse legal action.

## 9. Conclusion

Community trusts offer donors the opportunity to avoid the restrictions and limitations on private foundations yet still permit donor "advice" with respect to the use of donated funds. Other donors may prefer the donor control permitted by the pooled common fund of IRC 170(b)(1)(E)(iii) and the expanded charitable deduction applicable thereto even though private foundation rules are applied in other respects. Finally, the commercial donor directed fund should be scrutinized to determine if it qualifies under the various exempt organization provisions described in this topic. Since each commercial donor directed fund will vary depending on its facts, there is no blanket rule that can be applied to all cases.

In considering the issues discussed in this article, the Service's overriding concern is for the potential presented by commercial donor directed funds for undermining the private foundation rules in Chapter 42. As noted in Williams & Moorehead, An Analysis of the Federal Tax Distinctions Between Public and

Private Charitable Organizations, *supra*, at p. 2108:

As a result of the Tax Reform Act of 1969, the distinction between "public" and "private" charities became more pronounced. . . . Congress moved further to encourage gifts to public charities and, implicitly but necessarily, to discourage gifts to private foundations. Simultaneously, Congress enacted a series of statutory restrictions affecting only private foundations.

The General Explanation of the Tax Reform Act of 1969 by the Joint Committee on Taxation explained in some detail the Congressional purpose for each of the private foundation rules. Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1969, 91st Cong., 1st Sess., at pp. 29, 30-31, 36, 40-41, 46, 47-48, and 52-53 (Dec. 3, 1970). The new law was comprehensive and there was a logic and consistency to what Congress intended to accomplish. The Service will closely scrutinize artificial devices that attempt to avoid the private foundation rules. If control or ownership by a commercial donor directed fund of assets in a donor's sub-account is a fraud or lacks substance, appropriate legal doctrines will be employed to ensure proper treatment of the particular gift, fund, and/or organization.